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SUBJECT: ECONOMISTS OFFER MIXED OUTLOOK ON GOS ECONOMIC REFORMS

11. Summary: In a breakfast with the Ambassador, leading Spanish economists offered mixed views on the ability of Vice President and Minister of Economy and Finance Pedro Solbes to hold the line on sound economic policies in a heavily political cabinet. The economists cited as major policy challenges for the new government: reining in the budgets of the autonomous regions; reducing high housing costs without producing a collapse in the booming real estate sector; and carrying out labor reform to increase the productivity of the Spanish economy. The economists presented a healthy skepticism of the Socialist government's ability to seriously address these economic challenges. End Summary.

Solbes and the Economic Team v. the Government

12. On June 9, Ambassador Argyros hosted a breakfast for Spanish economists. The guests seemed to empathize with Vice President and Minister of Economy and Finance Pedro Solbes' unenviable position. The recently elected Socialist government ran a campaign calling for increases in education, R&D, the minimum wage, and transfer payments, while promoting a flat income tax and maintaining responsible fiscal policies. Some of these proposals, such as increased education spending and tax changes were modified, as the reality of the costs associated with implementing them proved difficult in light of the government's promise to maintain fiscal restraint.

13. The economists offered only praise for Solbes' "economic dream team". They noted that this team-up was no accident. Socialist leaders realize that the Popular Party (PP) government handled the economy well, and that the PP did not lose the election on economic issues. Therefore, Vice President Solbes intends to maintain the fiscal balance he inherited from the previous government as long as possible. The main challenge will be what one economist described as a slow bleeding effect on the budget. Socialist ministers will propose spending increases that are opposed by the economic team. The resulting compromises between the spenders and the budget guardians will yield a small increase in minimum wage here or a new social benefit there. The cumulative changes could derail the government's good reform intentions as aggregate spending slowly rises. The economists emphasized that Solbes and his team will need to remain vigilant.

14. The group agreed the Vice President needed Zapatero's political support to succeed. One economist stated, "it wasn't Rato who held the line on the Popular Party's budget--President Aznar inquired about the bottom line every day." However, no one knows what Zapatero really thinks about economic policy. Our guests noted a recent Zapatero statement contradicting Vice President Solbes, claim that the capital gains tax would not be raised by the Socialist government. They applauded Solbes' tough talk, but predicted that without Moncloa's (the Spanish White House) support, the economic team would have a difficult time resisting demands of ministers who carry more political weight in the cabinet.

Center-Regional Budget Issues

15. The group noted another challenge for the economic team will be reigning in the current deficit spending by some of Spain's autonomous regions. Some regional governments have called for greater budgeting power to augment increasing political powers. In light of Solbes' possible reconsideration of the 2001 Balanced Budget Law, which constrains regional budgets, the economists noted that some regional leaders, such as Catalonia's Pascual Maragall, may make budget negotiations with the regions very difficult.

Housing

16. The economists expected a soft landing for housing prices unless interest rates rise by more than 2%-3%; due to economic weakness in Germany, they do not expect this to happen. Such a change could lead to economic displacement, but an economist from one of the largest banks noted that Spain's banks would adjust mortgage terms if necessary to prevent widespread loan defaults. Another guest noted that a

negative change in the housing market would harm heavily invested developers far more than the average home owner; however, a drop in consumer spending and a slow-down in the construction industry could cause a negative wealth effect in the economy.

Labor Reform and Productivity

17. The economists mentioned labor reform as one of the most anticipated changes by the new government to increase productivity in Spain. The group agreed that high labor rigidity and inflexibility are major problems. However, no one has been able to divine what the government actually plans to do. Some union leaders are close to President Zapatero, but no one could predict whether this will facilitate or complicate necessary reforms.

18. One guest posited a litmus test for commitment to reform: the debate over commercial and retail regulation. Minister of Industry Montilla is proposing a reduction in retail hours. Solbes has been pushing to keep the current liberal regime. This is only one aspect of a deeper question: Will national policies be put in place to stop the encroachment of large wholesale retailers? Currently in Catalonia (Montilla's native region), local regulation requires large retailers to submit a business plan before developing a piece of property. This level of regulation makes it virtually impossible for large international retailers to enter the local market. It will be telling to see how this plays out.

Spain Still Good for U.S. Business

19. We noted concerns raised by some U.S. businesses that Socialist policies combined with anti-American election rhetoric could deter U.S. investment. The economists downplayed these fears, noting that Spain is still open for business. They agreed that Spain is and will remain a good place to invest and do business for U.S. companies.

Comment

110. In the first few months of the new Socialist government, few predictions can be made about the government's commitment to carrying out economic reforms or dealing with economic challenges. Our group of economists expressed uncertainty at Vice President Solbes, ability to maintain fiscal discipline without the full support of President Zapatero--still an unknown. The discussion led to a considerable list of concerns and worries about the government's (beyond the economic team) commitment to manage economic reforms. Whether the issue is maintaining balanced budgets, housing or labor reform, the economists presented a scrambled picture.
ARGYROS